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**U.S. TRADE REPRESENTATIVE CHARLENE BARSHEFSKY REACTS TO  
EUROPEAN ATTACK ON U.S. TAX LAW**

On July 1, the European Commission announced that it would request the establishment of a World Trade Organization (WTO) dispute settlement panel to consider its claim that the Foreign Sales Corporation (FSC) provisions of the U.S. Internal Revenue Code violate U.S. obligations under the WTO.

Reacting to this announcement, Ambassador Barshefsky stated: "I am extremely disappointed that the European Community has decided to reopen a matter which was long ago settled, especially as they have failed to respond to our requests for any evidence to suggest that European commercial interests have been disadvantaged. We will vigorously defend our WTO-consistent system of taxation against this unwarranted attack." The FSC provisions were enacted in 1984 following earlier European challenges in the GATT to the Domestic International Sales Corporation (DISC) provisions of U.S. tax law and U.S. challenges to GATT-illegal tax measures in Belgium, France and the Netherlands. "The FSC legislation was enacted expressly to conform to an understanding reached 17 years ago in the GATT which articulated the proper relationship between different systems of taxation and international trade rules," Barshefsky said. "This unjustifiable action cannot help but detract from our joint efforts to explore greater cooperation with the Community in the trade and economic spheres."

Background

On November 18, 1997, the EC requested WTO dispute settlement consultations, alleging that the FSC provisions are inconsistent with WTO rules, in particular with the Subsidies Agreement. On March 4, 1998, the EC expanded its complaint to include the Agreement on Agriculture. Three rounds of consultations were held in December 1997 and February and April of this year. The EC's request for a panel will be taken up at the July 23 meeting of the WTO's Dispute

Settlement Body. The EU's claim is that the FSC provisions constitute an export subsidy and an import substitution subsidy, both of which are prohibited under the WTO Subsidies Agreement, and that our failure to account for the FSC in implementing export subsidy obligations under the WTO Agriculture Agreement constitutes a violation of that agreement.

The FSC was introduced after the predecessor DISC provisions and certain European tax provisions were found to be prohibited export subsidies under the GATT. In adopting the ruling against the DISC and the European tax provisions in 1981, the GATT Council expressed an understanding (now also reflected in the WTO Subsidies Agreement) encompassing the following principles:

economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation;  
such processes should not be regarded as export activities in terms of GATT Article XVI:4, which essentially prohibits export subsidies on non-primary products;

arm's length pricing should be observed for tax purposes in transactions between exporting enterprises and related foreign buyers; and

GATT Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income.

The FSC rules are consistent with these principles. The FSC rules permit certain income generated outside the territorial limits of the United States to be exempt from certain U.S. taxes under conditions which reflect the understanding reached in 1981. To qualify for these exemptions, the FSC must have a foreign presence, meet certain management requirements and meet certain economic process requirements addressing both the extent and nature of the sales activities undertaken abroad as well as requiring that a minimum level of direct costs be incurred abroad with respect to certain sales activities (*e.g.*, advertising, order processing, etc.). Sales made through FSCs must also meet certain pricing requirements to qualify as foreign trading income eligible for the tax exemption; for sales between related parties, transfer pricing rules designed to approximate arm's length pricing are used to determine the FSC's foreign trade income.

The FSC provisions are used by a wide variety of U.S. industries, and legislation enacted last year extended and/or clarified their application to U.S. software firms.